TURNING ESG DATA INTO A COMPETITIVE EDGE FOR PRIVATE EQUITY

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CONTENTS

ABOUT OUR RESEARCH

This report reflects results of a survey of 20 top European private equity firms about how they handle environmental, social, and governance policies and the challenges ESG poses. The participating firms collectively represent about 30% of PE assets under management in Europe. The survey was conducted between April and July 2023 by Oliver Wyman and Novata.

In addition to a questionnaire, the survey included in-depth interviews with industry executives. The participating firms represent a wide range of assets under management — from just under $1 billion to more than $160 billion — as well as diverse sectors, geographies, and strategies.

As part of the survey, we discussed the firms' current ESG strategies and processes, looming challenges, and views on the future state of ESG in private equity. This report brings together these findings as well as insights generated by our survey and conversations. All data contained in the report have been anonymized and made non-attributable to any firm.

Introduction

TURNING ESG DATA INTO A COMPETITIVE ADVANTAGE

Environmental, social, and governance (ESG) considerations are here to stay.

Over the past 10 years, pushed by regulation and risk management concerns, ESG has evolved from a nice-to-have fringe corporate activity into a strategic necessity all private market participants must monitor and address. Today, European regulatory disclosure rules, including the Sustainable Finance Disclosure Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD), and European Union Taxonomy, all require eligible financial market participants to report ESG data publicly.

Thus, having a basic level of ESG competency is no longer a differentiator for private equity (PE) firms but rather the norm. This is true across Europe with similar regulations in the United Kingdom — the Sustainability Disclosure Requirements (SDR) and UK Green Taxonomy — expected to take effect by mid-2024.

In carrying out our analysis, we delineated four archetypes — basic, standard, enhanced, and best practice — that represent various states of ESG maturity across European PE funds, see Exhibit 1. These archetypes can be used to highlight the differences between engaging with ESG at a basic compliance level versus elevating ESG policies to a level that unlocks improved risk management and value creation — what we consider best practice. Under both enhanced and best practice, PE firms benefit from competitive advantage.

Exhibit 1: ESG archetypes

	Basic *We are responsive and flexible in our approach to ESG*	**Standard** *We implement ESG in line with regulatory standards*	**Enhanced** *LPs admire our ESG strategy*	**Best practice** *We are regarded as a market leader, known for driving the ESG agenda in the industry*
Strategy	Ad-hoc; reactive approach to regulations and market developments	Common across investments	Strategy and targets are embedded across processes	Innovative; seeks to drive agenda across the industry
Governance	Unstructured, piecemeal policies not integrated in strategy; have ESG exclusion criteria in place	Formalised and consistently applied; industry standard frameworks are followed	Encompass broad coverage of policies and frameworks across processes	Policies are regularly reviewed; ESG team reports to CEO or CEO-1
Core processes	Reactive; managing issues as they arise	Consider ESG risks & opportunities; regular ESG audits likely performed	Encompass ESG communications, performance management with targets in place, regular reporting	Include specific ESG practices, e.g. specialized ESG reporting to LPs; ESG DDs; sharing ESG targets and value creation ideas at exit
Metrics	A few EDCI[1], SASB[2], GRI[3] metrics are tracked; mostly qualitative	Some quantitative metrics are tracked; metrics track adverse impacts and risks more than actions and opportunities	Cover all aspects of ESG; metrics collection systems are in place; metrics are collected more frequently than annually	Cover all aspects of ESG incl. impact & ESG value creation metrics; collect metrics quarterly
Data	No frameworks or processes in place to manage data	Data management reliant on simple, generic tools e.g. Excel	Data management systems in place and data management processes are reviewed regularly	Use best in breed data management systems and processes

Source: Oliver Wyman, Novata

Most European PE firms today across the “standard” and the “enhanced” archetypes, having successfully:

- Established a public firm-level ESG strategy
- Appointed heads of ESG or an ESG governance structure within the firm
- Considered some ESG risks (and potentially ESG opportunities) at points in the investment lifecycle, such as due diligence or exit
- Recognized and tracked basic ESG key performance indicators (KPIs), such as carbon emissions

1 ESG Data Convergence Initiative

2 Sustainability Accounting Standards Board

3 Global Reporting Initiative

To elevate ESG beyond a mandatory administrative cost and into a competitive advantage, firms now need to identify the value in ESG data above and beyond compliance and incorporate it into their decision-making. Firms with a best-practice approach to ESG embed policies in all commercial functions and day-to-day business. This will enable firms to begin connecting ESG directly with financial performance or value creation considerations and act faster upon opportunities.

Firms that are able to wield ESG as a competitive edge in coming years will enjoy stronger reputations with limited partners (LPs), the public, regulators, the corporate community, and the media. Among its many commercial upsides, embracing ESG in this way can be expected over time to reduce operational inefficiencies, generate revenue from ESG-friendly products and enhanced customer loyalty, and better prepare firms for regulatory changes. To achieve this, the industry must deal with the challenges that accompany ESG.

TOP CHALLENGES FACING PRIVATE EQUITY

None of this is to say that turning ESG into a competitive advantage is straightforward or easy. While European PE firms are generally eager to develop ESG strategies to create competitive advantage, they face obstacles in doing so. Here are the four hurdles most frequently identified by survey participants:

- **The inability to quantify the financial impact of ESG**, even though 100% of firms we surveyed indicated they see ways in which ESG contributes to financial performance
- **The resource-intensive nature of managing ESG metrics across diverse portfolios**, which is a serious problem confronting generally lean ESG teams in PE firms
- **The burden of meeting diverse demands for data from LPs** on top of regulatory requirements, which takes away resources that could be better spent on initiatives to expand ESG's strategic role
- **The sheer, unwieldy volume of ESG metrics**, which complicates the use of ESG data to inform in investment decisions.

Firms must tackle these challenges if they are to achieve the strategic use of ESG data in decision-making and demonstrate ESG best practices.

ESTABLISHING A CORRELATION BETWEEN ESG AND FINANCIAL PERFORMANCE

It is widely accepted in Europe today that having strong ESG policies and infrastructure can contribute to strong financial performance — for both portfolio companies and PE firms. Our survey respondents all identified numerous ways in which this is evident — from improved brand perception and loyalty and increased revenue potential to better preparedness for more demanding regulation.

That said, many firms today still find it difficult to track a direct correlation between ESG compliance and financial performance. ESG teams spend valuable time and resources trying to marry ESG metrics with financial statements.

One approach to establishing this correlation is to identify the components of E, S, and G that can be tracked in financial terms and focus on measuring those. More quantifiable ESG initiatives, such as decarbonization efforts, can be evaluated in terms of cost or savings for a company. For instance, if a lender provides a fund or portfolio company with a loan at a more favorable rate on the basis of its enhanced sustainability, that becomes a measurable financial impact[4]. Using such quantifiable measures can help gauge ESG's impact on financial performance.

Admittedly, funds must still deal with a trove of ESG components that cannot be so easily married to financial impact. Intangible ESG considerations, such as brand perception and corporate culture, are harder to put a number on and tie to balance sheets. PE firms can instead consider these kinds of ESG policies as exercises in value creation or risk management, two areas where the correlation is clearer.

4 Sustainability linked loans (SLLs) are defined as loans following the sustainability linked loan principle (SLLP), which sets Sustainability Performance Targets (SPTs) and determines KPIs to monitor sustainable performance. The number of SLLs issued rose by ~126% p.a. in the period 2018-2022 globally, with the majority issued in Europe.
Source: Refinitiv, OW Analysis, 2018-2022

Exhibit 2: In what ways do you see strong ESG performance impacting financial performance? % of respondent

Source: Oliver Wyman, Novata

Companies will ultimately be unable to thrive without incorporating ESG into day-to-day business. Especially in Europe, the ever-increasing expectations of LPs and investors, consumers, and the media around ESG — in addition to a spate of new laws — are already institutionalizing ESG in business practice. And given the increasingly negative manifestations of climate change and the potential for unfavourable publicity for ESG non-compliance, companies will not want to be seen to be on the wrong side of the issue. For instance, all our survey respondents already report that they routinely collect data points from their portfolio companies related to their impact on the environment and nature and rely on ESG metrics at various points throughout an investment's lifecycle.

MANAGING ESG ACROSS A DIVERSE PORTFOLIO

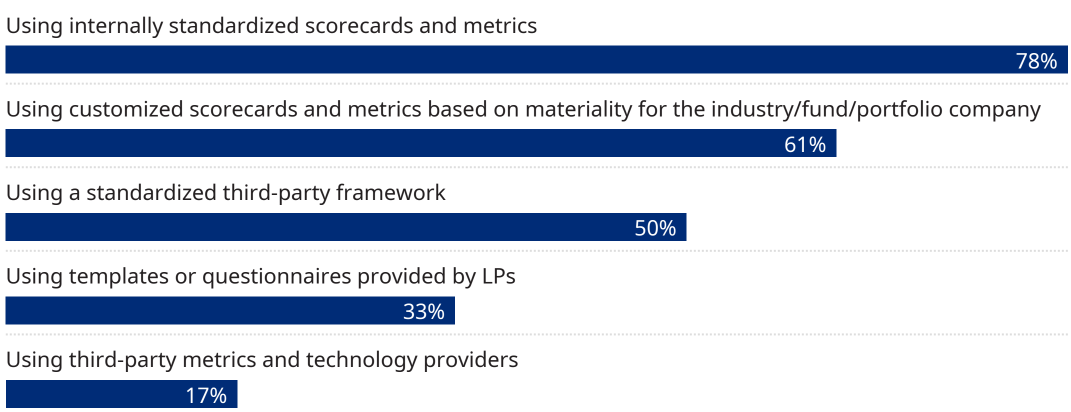
Private equity firms need to track ESG performance across portfolio companies just like they need to track financial performance, but reporting metrics across a diverse portfolio is particularly challenging with ESG. Unlike in financial performance where universal frameworks and a commonly established language exist, ESG data lack standardization and widely accepted benchmarks.

Lacking the commonalities existing in financial reporting makes tracking ESG metrics inefficient and time-consuming. PE firms struggle with what to measure, what constitutes strong performance, and how to choose meaningful benchmarks. This is a particular challenge in PE because of how lean ESG teams tend to run.

Furthermore, which metrics to track differ across the various dimensions of environmental, social, and governance policy variables as well as the lifecycle of the investment. Survey respondents were fairly varied in terms of how they define and select ESG metrics for portfolio companies today.

Frameworks, such as the ESG Data Convergence Initiative (EDCI) and the United Nations Principles of Responsible Investing Due Diligence Questionnaire (UN PRI DDQ), have been developed to address the lack of standardization in ESG data today. While these frameworks have the potential to greatly enhance the comparability and usefulness of ESG data points for PE firms, they will need to strike a careful balance between materiality and standardization.

Exhibit 3: How do you define and select quantified metrics and scores?
% of respondents that use metrics in some part of the investment lifecycle



Source: Oliver Wyman, Novata

The benefits of tracking standardized metrics among portfolio companies are well established. Standardization enables firms to compare ESG performance across a portfolio, identify timeseries trends, benchmark performance, and use consistent metrics when reporting. This in turn makes it easier for LPs, regulators, and internal teams to understand what the data show.

However, metrics also need to be material to the company in question if they are to serve as effective ESG indicators and constructively inform commercial decision-making. PE firms need to focus on the most relevant and significant issues, which can differ between industries — and even between companies within an industry.

Here are example approaches, currently used by two of the largest European PE firms today:

- One firm determined that it needed to track both uniform and bespoke ESG metrics across its investments. To do this effectively, it first identified core ESG themes, such as climate impact and board diversity, for which it requires all portfolio companies to track KPIs. The firm then engages in bilateral conversations with portfolio companies to determine additional bespoke material KPIs to be tracked as well as the core metrics.
- Another firm with a strong ESG focus is in the process of establishing an Article 8 environmental and/or social fund, in keeping with the SFDR rules. The firm created fund-wide targets at the outset, and as a condition of investment, companies must agree to what will be measured and reported as well as the targets.

BRINGING MORE EFFICIENCY TO REPORTING

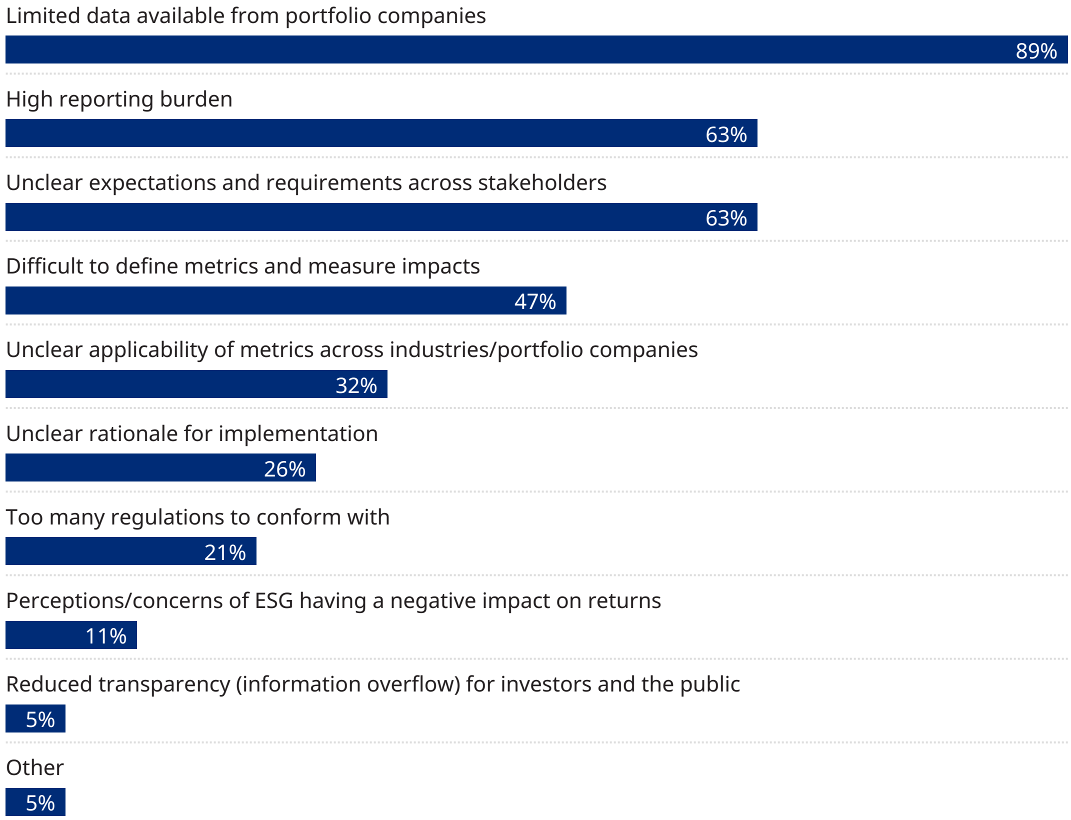
ESG reporting to shareholders is currently inefficient because of the sheer volume and variety of reporting requests. This is an issue that faces firms when reporting to their LPs, and also portfolio companies reporting into their owner.

European PE firms need to collect ESG performance data from portfolio companies and report into LPs for regulatory reasons in line with SFDR. They are also incentivized to demonstrate that they share ESG ambitions with LPs to maintain good relations and successfully fundraise. Portfolio companies need to report as required by their shareholders, which may be in line with, or above and beyond, SFDR disclosure.

This magnitude of reporting represents a significant time and resource burden for all those involved. Our survey revealed that more than three-quarters (78%) of firms surveyed proactively share ESG policies and investment strategies with their LPs, but 72% are still required to respond to additional questions and requests from LPs.

PE firms are also aware that their ESG reporting ask of portfolio companies is often a burden, which costs time and resources. Data points to report are often difficult for portfolio companies to ascertain, and reporting is frustrating and time consuming.

Exhibit 4: What challenges have you encountered while implementing regulatory requirements? % of respondents



Source: Oliver Wyman, Novata

If a firm report into multiple LPs, or if portfolio companies report into multiple owners, reporting frameworks, processes, and cadences are rarely aligned among the various shareholders.

Survey respondents indicated that reporting can be particularly frustrating when requests come for metrics that go beyond "business as usual" tracking. Many of these requests are considered not directly relevant or material to track on an industry/asset agnostic basis, and any time spent reporting these metrics is therefore not a value-add to the company's day-to-day business.

Reporting initiatives are underway that could lead to the consolidation of non-regulatory ESG reporting to shareholders, but the sheer number of LPs in Europe means that the bar is high for a critical mass to be reached which creates tangible efficiencies. As regulatory and non-regulatory frameworks such as SFDR or the Task Force on Climate Related Financial Disclosures (TCFD) become increasingly well established over time, the increased standardization should save both money and time for LPs, PE firms, and portfolio companies alike. These savings can be better spent on ESG value creation in ESG strategy, screening opportunities, and tracking performance, to name a few possibilities.

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INTERVIEW QUOTES:

The questionnaires we have to fill out for our LPs are not standardized. For example, some care about Diversity & Inclusion while others heavily focus on carbon emissions.

The data requests we currently get from LPs are so long as to be unreasonable.

We are aware that we share reporting requests with our portfolio companies that are not aligned with other reporting templates they may need to complete, [but] that is the information we need to collect for our internal and external reporting needs.

MAKING THE MOST OF ESG DATA TO ENABLE BETTER DECISION-MAKING

More ESG data is available to the private equity industry now than ever before — whether from individual portfolio companies or fund-level data points. More than half of our survey respondents track metrics across at least seven E, S, and G categories today. Industry-wide, firms need to leverage this data effectively when making investment decisions if ESG is to become a competitive advantage.

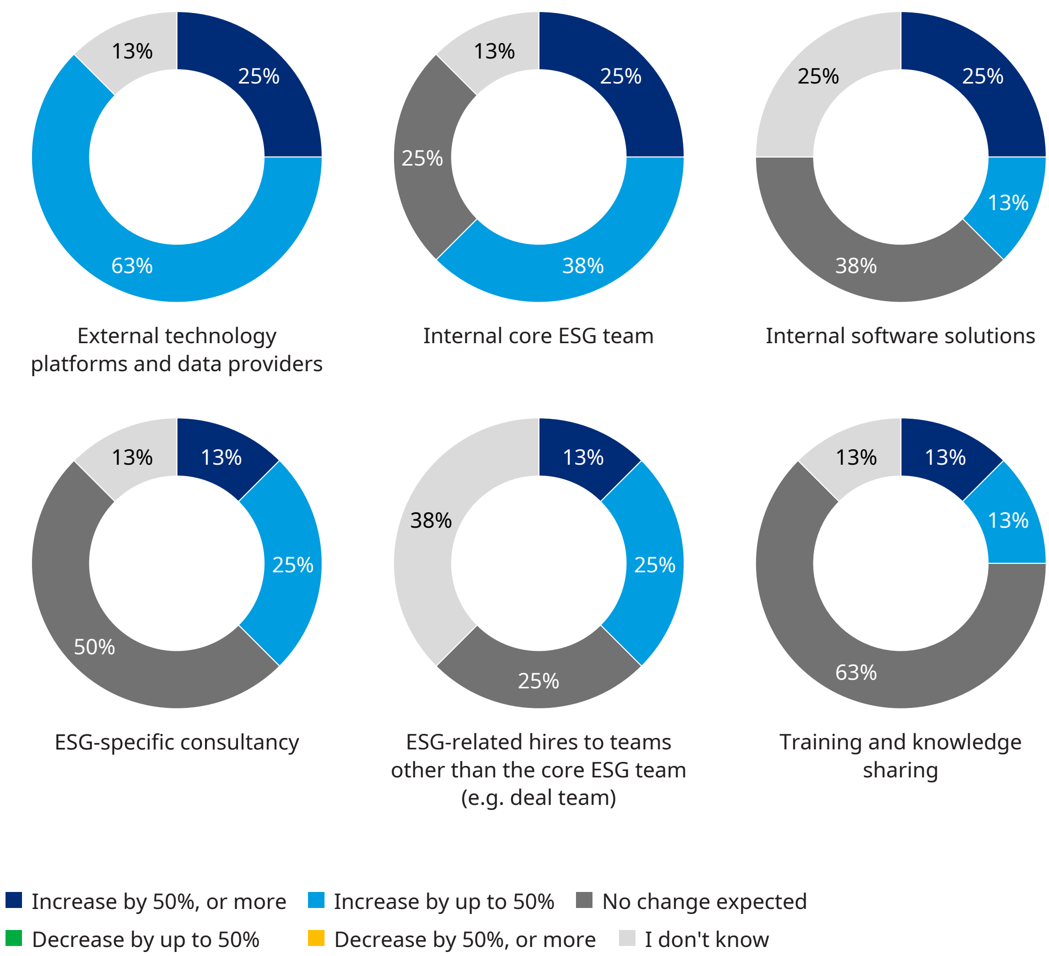
Exhibit 5: Which types of ESG metrics are you tracking internally?
Please select all that apply, % of respondents

Source: Oliver Wyman, Novata

To better leverage ESG data, the quality of the data inputs needs to be improved. While the goal is for clean, standardized, timely, and consistent data inputs, that standardization is right now lacking, and firms are not currently able to use data to its full potential. Only 37% of respondents see the use of ESG metrics as a differentiator for their firm. There is clearly space for a vast amount of value creation if firms can leverage data more effectively.

Firms are investing in the space, a move that is long overdue. Our survey respondents indicate that they plan to increase their spending over the next three years on everything from additional personnel and training to software and technology platforms in an effort to better leverage ESG data. Interestingly, no survey respondents expect to see a decrease in ESG spend on any front in the next three years.

Exhibit 6: In the coming three years, how much do you expect your costs for ESG-related activities, tools and functions to change?
% of respondents selecting each answer



Source: Oliver Wyman, Novata

There is also an ongoing resourcing question in PE when it comes to ESG. The ESG teams we surveyed report working with a lean staff of typically two to four people and often with staffers with no more than a few years' experience in the space. This forces teams to make hard decisions about where to focus their energy. Survey respondents indicate that they expect spending on internal ESG teams to stay generally the same or maybe increase somewhat over the next three years. Assuming PE firms retain ESG staff, these teams should grow increasingly experienced.

Conclusion

THE TIME TO ACT IS NOW

Given the heightened attention on climate and sustainability in general, PE firms need to keep prioritizing ESG today to stay ahead of growing demands from their investors, the banks, regulators, and the public. Already, we have seen significant shifts in the European ESG landscape in recent years:

- Regulatory mandates have come into action
- European funds have established basic infrastructure to engage with ESG
- The amount of ESG data is continually expanding
- New frameworks for ESG monitoring, such as the TCFD, are being developed

In light of the above, PE firms need to eke out a return on their investment in ESG; they need to leverage ESG as a competitive edge to justify the investments. Turning ESG data into a competitive edge offers both value creation and risk management opportunities to those funds who take them, and with increasing standardization, we expect to see eventually better correlation between robust ESG data and strong financial performance.

The momentum that has been established in recent years will not abate any time in the near future, so firms need to keep up or risk falling behind peers and losing what could be a key competitive advantage. European regulators have significantly shaped the ESG landscape in recent years with the passing of regulation like CSRD and SFDR. As a result, there is a risk that the PE industry will not remain proactive about shaping its own agenda and rely instead on regulators. Such a trend would impair the industry's ability to use ESG for value creation and as a competitive advantage.

Private equity firms are particularly well placed within the broader investment community to benefit from value creation opportunities based around ESG improvement because of their longer investment timelines and (often) majority ownership. Thus, PE industry voices need to be involved in leading the charge on ESG to ensure that the focus remains connected with value creation incentives.

The opportunity for firms to "win" at wielding ESG is here. Firms who are able to adopt ESG best practices ahead of their peers will enjoy long-term commercial advantages, while those that procrastinate will eventually fall behind.

If you have further questions about our research, please reach out to Sofia Gardefjord, sofia.gardefjord@oliverwyman.com or Katie Stueber, press@novata.com

Novata is a public benefit corporation that empowers the private markets to achieve a more sustainable and inclusive form of capitalism. Novata's technology platform makes navigating the ESG landscape simple for private markets by identifying a clear starting point for selecting the metrics that matter, streamlining data collection, and contextualizing data to drive reporting and action. Novata, which is backed by the Ford Foundation, Hamilton Lane, Microsoft, Omidyar Network, and S&P Global, is majority controlled by mission-driven organizations and its employees. For more information, please visit https://www.novata.com.

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